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No. 296

IN THE

Supreme Court of the United States

October Term, 1944

PANHANDLE EASTERN PIPE LINE COMPANY, ILLINOIS NATURAL GAS COMPANY, AND MICHIGAN GAS TRANSMISSION CORPORATION,

Petitioners,

vs.

FEDERAL POWER COMMISSION, CITY OF DETROIT, COUNTY OF WAYNE, MICH., MICHIGAN CONSOLIDATED GAS COMPANY, AND MICHIGAN PUBLIC SERVICE COMMISSION,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

BRIEF FOR THE PETITIONERS.

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INDEX.

Constitution and Statutes—

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OPINIONS BELOW.

The opinion of the court below (R. XVI, 7198)[1] and the dissent thereto (R. XVI, 7218) filed June 6, 1944, are reported in 143 F. (2) 488. The opinion and order of the Federal Power Commission (R. I, 14-43) are reported in 45 P.U.R. (N.S.) 203.

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[1] In the record citations, Roman numerals refer to the volume, and Arabic numerals refer to the page.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 6, 1944 (R. XVI, 7219). The petition for a writ of certiorari was filed on July 28, 1944. The petition was granted November 13, 1944, limited to the third question presented by the petition. By order of this Court entered January 3, 1945, the scope of review was enlarged to include the second question presented by the petition. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, and Section 19(b) of the Natural Gas Act.

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act, approved June 21, 1938 (52 Stat. 821; 15 U.S.C. 717), are set forth in Appendix A. The section of the Act primarily involved is Section 1(b), which reads as follows:

> (b) The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but *shall not apply to any other transportation or sale* of natural gas or to the local distribution of natural gas or to the facilities used for such distribution *or to the production or gathering of natural gas.* (Emphasis supplied.)

QUESTIONS PRESENTED

(1)* Whether the Commission's action in treating petitioners' business as an entirety and refusing to make any allocation or separation with respect to petitioners' regulated and unregulated sales was beyond its statutory power.

*Presented as question (3) in the Petition for Certiorari.

(2) Whether limiting the sale price of petitioners' gas for resale so as to provide an over-all return of 6½ per cent on the depreciated cost of petitioners' properties including those devoted to production and gathering of natural gas and excluding petitioners' tendered evidence as to the market value of petitioners' gas leaseholds constituted an exercise of jurisdiction over production and gathering of natural gas in violation of the Natural Gas Act.

STATEMENT.

On February 28, 1941, the City of Detroit and the County of Wayne, Michigan, filed a complaint before the Commission against Panhandle Eastern Pipe Line Co., alleging that its rates and charges for natural gas sold to Michigan Consolidated Gas Company for resale in that City and County were unreasonable, unjust, and unduly discriminatory (R. XVI, 7002). The Commission, on its own motion, instituted an investigation of all wholesale natural gas rates and charges of petitioners (R. XVI, 7061, 7088). These proceedings were consolidated (R. XVI, 7064). After a lengthy hearing before the Commission's trial examiner, the Commission, on September 23, 1942, entered in such consolidated docket the order under review here, requiring petitioners to file new schedules of rates and charges for, or in connection with, their transportation and sale of natural gas in interstate commerce for resale for ultimate public consumption, so as to reflect, when applied to their 1941 transportation and sales, a reduction of not less than \$5,094,384 per annum below their 1941 consolidated gross operating revenues of \$17,789,573 (R. I, 38, 42). On October 30, 1942, petitioners' motion for rehearing and reconsideration, seasonably filed (R. XVI, 7141), was denied (R. XVI, 7150).

Thereupon, petitioners promptly filed in the United States Circuit Court of Appeals for the Eighth Circuit (in

whose jurisdiction petitioners had their principal place of business) their petition for review of said order of the Commission (R. I, 1). On June 6, 1944, that court rendered the judgment under review here, affirming the order of the Commission (R. XVI, 7219).

The properties of petitioners (now owned by Panhandle Eastern[2]) constitute a natural gas production, transportation and marketing system. The system produces and purchases gas from the Panhandle Field in Texas and from the Hugoton Field in Kansas, Oklahoma, and Texas. It extends from the Panhandle Field and the Hugoton Field through the states of Oklahoma, Kansas, Missouri, Illinois, Indiana, Ohio, and Michigan, with termini in Indiana, Ohio, and Michigan. (A map of the system, as of 1941, appears in Appendix B.) When the proceedings before the Commission were commenced, Michigan Gas, a wholly owned subsidiary of Columbia Gas and Electric Corporation, owned that portion of the then existing transmission system extending eastward from Dana, Indiana. Michigan Gas purchased its entire supply of natural gas from Panhandle Eastern and sold such gas to various distributing companies for resale. It also transported for the account of Panhandle Eastern gas sold by Panhandle Eastern directly to various distributing companies serving communities in Ohio and Michigan. Illinois Natural, a wholly owned subsidiary of Panhandle Eastern, owned the lateral lines in the State of Illinois extending from Panhandle Eastern's main line and purchased its entire supply of gas from Panhandle Eastern and sold such gas to distributing companies and industrial companies in Illinois (R. I, 17-18).

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[2] In this brief we refer to Panhandle Eastern Pipe Line Company as "Panhandle Eastern", Illinois Natural Gas Company as "Illinois Natural", and Michigan Gas Transmission Corporation as "Michigan Gas".

Panhandle Eastern purchased Michigan Gas February 6, 1942, and dissolved it March 31, 1943, after acquiring all of its properties. Illinois Natural, a wholly owned subsidiary of Panhandle Eastern, was dissolved March 31, 1943, after the latter acquired

At the hearing, petitioners caused to be identified and offered in evidence certain exhibits, and testimony relating thereto, which would have shown the market value of petitioners' gas leaseholds. The Commission's trial examiner sustained a motion to strike and exclude the exhibits above referred to and all testimony in support thereof (R. II, 715-718; R. VIII, 3973-3975). At the time the evidence was tendered, counsel for petitioners made it clear that it was offered as being relevant not only to a determination of what rate base should be used and what rate of return should be applied but also to a determination of the present value of petitioners' property and to a determination of the return in dollars which they are justly and equitably entitled to receive (R. II, 714-715).

The Commission approved the trial examiner's action in striking all evidence of the fair value of petitioners' leaseholds, basing its ruling upon its construction of the Natural Gas Act.[3]

The excluded evidence would have shown that the present value of Panhandle Eastern's leaseholds, as reflected in their market value, is $8,339,722 (Ex. 39, R. IX, 4199, 4201, 492) while the book cost of such leaseholds, less reserves for depletion amounted to $955,096,[4] a difference of $7,384,626.

[3] The Commission in its opinion stated: "We held in the Chicago District Electric Generating case that under section 208(a) of the Federal Power Act (the provisions of which are identical with Sec. 6(a), supra) that reproduction cost evidence is inherently fallacious and should be disregarded under that statute." (R. I, 19). It may be observed that the Commission's opinion in the cited case, 39 P. U. R. (N. S.) 263, has never been reviewed by any Court. Furthermore, no properties comparable to gas leaseholds were involved in that case.

[4] Cost of leaseholds was $1,745,206 (Ex. 52, p. 1, LL. 10 and 12—R. IX, 4275), and reserves for depletion, etc. aggregated $790,110 (Ex. 48, p. 2, LL. 10 and 33—R. IX, 4261). These leaseholds were acquired through foresight and good judgment at low prices prior to a determination of the limits of the field and principally over a period from 1930 to 1932.

The excluded evidence was tendered through a witness of many years' experience in the Panhandle and Hugoton fields. During this experience he had bought and sold many leases, both on his own behalf and as broker. He was not in any way connected with petitioners. His analysis of the market value was based on a knowledge of the locations of the various wells and an examination of each of the leases. He took into consideration the unitization agreements which Panhandle Eastern had obtained from its lessors, the subjection to outside drainage, the productivity of each drilled lease,[5] the productivity of the undrilled leases as indicated by nearby production, the rock pressures, and other matters appropriate for consideration in arriving at market value (R. IX, 4190). After having reviewed each lease separately, he placed it in a certain classification representing what was, in his opinion, the then market value of the lease "from a willing seller to a willing buyer" (R. IX, 4195). He then tabulated the number of leases in each classification, fixing a market value as to each classification ranging in the Panhandle Field from $5 per acre to $100 per acre and in the Hugoton Field from $5 per acre to $35 per acre (R. IX, 4199-4201). In the tendered narrative of his testimony, he stated (R. I, 4198):

> In valuing the leases of Panhandle Eastern Pipe Line Company, I have not considered as a value factor the fact that the wells drilled thereon are connected to pipe lines; nor have I attempted to place a value upon the wells or equipment used in connection therewith. The values shown in the tabulations reflect merely the present market value of the leases, accord-

[5] The average open flow potential in 1940 for the West Sweet Panhandle Field (in which petitioners' wells in the Panhandle Field were located) was 16,019 MCF daily, whereas the open flow potential of petitioners' wells was 25,025 MCF daily (R. IX, 4129, ll. 2 and 3, col. D).

> ing to my judgment. It is my opinion that if this acreage reserve owned by the Panhandle Eastern Pipe Line Company in the two fields was available, it could unquestionably secure an outlet for its gas, exclusive of any pipe line now in the fields and could be sold at the valuation fixed by me.

The valuation of $8,339,722 placed by the witness upon petitioners' 264,971 acres of gas leaseholds shows an average value per acre of approximately $31, whereas the average value per acre under the Commission's valuation was $3.60.

The evidence admitted by the trial examiner showed that, for 1940 (the last full year for which statistics were available at the time), petitioners paid for purchased gas an average field price of 3.8429¢ per MCF, whereas for their own produced gas, under the Commission's formula, petitioners would have received only 2.9924¢ per MCF. Comparable figures for the year 1941 (based in part on estimates) were: 3.8336¢ per MCF paid by petitioners for purchased gas and 2.8272¢ per MCF allowed by the Commission to petitioners for their own produced gas.[6]

The evidence also showed that there were thirty-four wells jointly owned by petitioners and others, the gas from which flowed into petitioners' transmission system (R. IX, 4153). Under gas purchase contracts, petitioners paid the co-owners of the wells for the latter's share of the production 5¢ per MCF (R. III, 1107). The Commission found no fault with this price in its allowance of operating expenses; yet, by reason of its valuation of petitioners' gas leaseholds at only depreciated original cost, the effect of the Commission's order was to allow petitioners only 2.8272¢ per MCF for their share in the production from these wells in 1941.[7]

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[6] See computations with record references, Appendix C.
[7] See computations with record references, Appendix C.

The evidence also showed that petitioners owned a particular group of thirteen producing wells, the gas from which was sold to Argus Natural Gas Company for distribution in nearby towns in Kansas. The wells were not even physically connected with any part of petitioners' transmission system, but were connected with the gathering system of Argus Natural Gas Company (R. I, 255-256; XIII, 5893; IX, 4133). The revenue derived from sales of gas from these wells to the Argus Natural Gas Company amounted to $67,365.40 for the year 1941. The average price paid by Argus Natural Gas Company to petitioners for this gas at the wellhead was 6.13¢ per MCF (R. XIII, 5707, l. 32). The Commission included all of these wells and the revenue derived therefrom in its unit treatment of petitioners' business.

Most of the gas sold by petitioners is sold to distributing companies for resale, but a very substantial quantity is sold direct to industrial customers for consumption by them. For the year 1941 direct sales represented 13.2% of all gas transported and sold (R. I, 33). The revenue derived therefrom amounted to $1,500,527 (R. XIII, 5947, Ex. 251, L. 23, Col. F). There was testimony to the effect that $128,848 of the entire investment in plant was used exclusively in serving industrial consumers purchasing gas directly from petitioners (R. I, 33). A very substantial part of the investment in plant was used exclusively in serving distributing companies buying for resale. A map of the system (Appendix B) upon which the locations of the nineteen industrial customers served in 1941 are indicated shows that all of the transmission system from Zionsville, Indiana, to Detroit, Michigan, was used exclusively in serving customers buying for resale.

Petitioners presented at the hearing a suggested basis for an allocation between the regulated and the non-regulated sales (R. XIII, 5947, Ex. 251; R. VIII, 3631-3676,

3857). The Commission's staff also presented a suggested allocation (R. XVI, 6883-6887, Ex. 263; R. VIII, 3994-4002). The Commission refused, however, in its rate reduction order, to make any separation of property or to make any allocation with respect to petitioners' regulated sales and non-regulated sales or to make any findings upon which such separation or allocation could be based; it treated petitioners' business as one subject to regulation in its entirety (R. I, 34).

The Commission allowed petitioners a return of $4,363,-925, 6½% on a rate base selected by it, $67,137,305 (R. I. 30). This rate base was determined on the basis of petitioners' business as an entirety without regard to the fact that a substantial portion of petitioners' sales and their business of production and gathering were expressly excluded from the Commission's jurisdiction by the Natural Gas Act.

On review, the court below, with one judge dissenting, affirmed the Commission's order.

SPECIFICATION OF ERRORS TO BE URGED.[8]

The court below erred:

1. In affirming the order of the Federal Power Commission.

2. In failing to set aside the order of the Federal Power Commission.

3. In failing to hold that the Commission's action in treating petitioners' business as an entirety and refusing to make any allocation or separation with respect to petitioners' regulated and unregulated sales was beyond its statutory power.

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[8] This specification adheres in substance to the assignments of error urged before the Commission in the application for rehearing (R. XVI, 7141-7148) and to the specification of errors in the petition to review (R. I, 7-12).

4. In holding that the Commission can, consistently with the Natural Gas Act and Article V of the Amendments to the Constitution of the United States, limit the sale price of petitioners' gas for resale so as to provide an over-all return of $6\frac{1}{2}$ per cent on the depreciated cost of petitioners' properties, including those devoted to production and gathering of natural gas, excluding petitioners' tendered evidence as to the market value of petitioners' gas leaseholds.

SUMMARY OF ARGUMENT.

I.

THE COMMISSION'S ACTION IN TREATING PETITIONERS' BUSINESS AS AN ENTIRETY AND REFUSING TO MAKE ANY ALLOCATION OR SEPARATION WITH RESPECT TO PETITIONERS' REGULATED AND UNREGULATED SALES WAS BEYOND ITS STATUTORY POWER.

A. The Natural Gas Act excludes direct sales from the rate making powers of the Commission.

Section 1(b) of the Natural Gas Act (Appendix A) specifically provides that the provisions of the Act shall apply to the transportation and sale in interstate commerce of natural gas *for resale* for ultimate public consumption, but *shall not apply* "to any other transportation or sale of natural gas". It necessarily follows that a direct sale to an industrial consumer for such consumer's own use is not subject to the rate making powers of the Commission.

The legislative history of the Natural Gas Act makes it clear that Congress regarded sales of natural gas by a natural gas company to industrial customers for such customers' own use as not imbued with a public interest and that it was the intent of Congress that such sales should be free from regulation.

B. The Commission failed and refused to observe the statutory limitation on its powers and to make the necessary findings and requisite allocations.

The Commission has recognized its lack of jurisdiction over direct sales in proceedings before it involving other "natural-gas companies" and, in such proceedings, has made allocations supported by specific findings.

The Commission refused in the case at bar to make any allocation, although the Commission's staff and petitioners presented for the Commission's consideration detailed plans for allocation.

The Commission failed to make the necessary findings required by the evidence before it. The Commission made no finding as to the component parts of petitioners' consolidated gross operating revenue, $17,789,573, which included all of the revenue from petitioners' unregulated sales and which petitioners were required to reduce by $5,094,384. There is no finding of any kind relating to allocation.

The order cannot be sustained upon findings so inadequate, in the face of the undisputed facts that (a) 13.2% of all gas sold was not sold for resale but for consumption by the purchaser; (b) $1,500,527 of the gross revenue was derived from such direct sales; (c) $128,848 of the plant investment was used exclusively in the service of direct industrial customers; and (d) the entire transmission system from Zionsville, Indiana, to Detroit, Michigan, was used exclusively in the service of customers buying gas for resale.

The Commission's reasons for failing to make an allocation, stated in its opinion, afford no support for such failure.

The Commission erred in its assumptions (1) that petitioners carried the burden of "showing that the direct industrial sales are so distinct and separate from the general wholesale business that the two cannot here be considered together" and (2) that it could treat all of the business of petitioners "as an entirety requiring no allocation as between the two classes of sales" simply because it appeared reasonable to the Commission to do so.

It is not responsive to the issue for respondents to say that the action of the Commission was "supported by substantial evidence and cannot be said to lack a rational basis".

The question is whether the Commission exceeded the statutory limitation upon its powers. "Only when statutory standards have been applied can the question be reached as to whether the findings are supported by evidence."

The plain fact is that the Commission exceeded its jurisdiction. In determining the amount of the rate reduction ordered, the Commission failed to separate transactions which were within its jurisdiction and those which were beyond its jurisdiction.

As a result, there is a "congenital infirmity" in the order, which renders it void and unenforceable.

C. The Court below erred in holding that no allocation was required.

The court below upheld the Commission's action on the erroneous assumption that "if a segregation had been made it would not materially have affected the result".

The Commission made no findings addressed to the evidence bearing on allocation examined by the court below; it made no segregation or any findings showing what the result of a segregation, if made, would be; and it made no findings in support of the conclusion (imputed to it by the court below but not found in the opinion or findings of the Commission) that, "if a segregation had been made, it would not materially have affected the result".

The court below completely ignored the fact that, in reaching their respective estimates of "cost of service" allocable to the unregulated sales, both the witness for the

Commission's staff and the witness for petitioners had made *pragmatic adjustments* which were not reviewed by the Commission, and *upon which the Commission had made no findings whatever.* The absence of this essential element of the legislative process delegated to the administrative body appears to have been completely overlooked by the court below.

The decisions of this court are uniform in holding that, where part of a regulated business is not subject to regulation, the regulatory body must make an appropriate separation or allocation of property, revenue, and expense as between the regulated and non-regulated transactions.

D. The order of the Commission should be set aside.

The failure of the Commission to make the necessary separation of property, revenue, and expenses as between the sales subject to regulation and the sales not subject to regulation renders its order null and void. Under the provisions of the Natural Gas Act, the order should be set aside. Although Section 19(b) of the Natural Gas Act (Appendix A) provides that, upon review, the Court may modify an order of the Commission, relief to petitioners by modification of the order is impossible here because the legislative process is incomplete and forms no adequate basis upon which the Court can modify the order without departing from the judicial function and performing the legislative function.

II.

THE COMMISSION CANNOT, CONSISTENTLY WITH THE NATURAL GAS ACT AND WITH DUE PROCESS OF LAW, RESTRICT THAT PART OF PETITIONERS' EARNINGS DERIVED FROM THEIR PRODUCING AND GATHERING PROPERTIES TO 6½ PER CENT ON THE DEPRECIATED ORIGINAL COST OF SUCH PROPERTIES.

By Section 1(b) of the Act, Congress expressly provided that the provisions of the Act *shall not apply to the production or gathering of natural gas.*

When the provisions of Section 1(b) are considered together and in their relation to the whole scheme of regulation, particularly the declared policy set forth in Section 1(a) of the Act, the conclusion is inescapable that the intent of Congress was to exclude from regulation the entire business of production and gathering, including the interstate sale of gas by the producer thereof even though it could constitutionally regulate such sale; likewise, to exclude from regulation the production and gathering phase of the business of a "natural-gas company" engaged in interstate transportation and sale.

It is the *service* of transporting gas to the interstate markets that Congress declares to be imbued with a public interest and to require regulation. Where Congress has authorized price fixing with respect to *a Commodity,* as distinguished from *a service,* it has not delegated to the administrative agency freedom of action within the broad limits of the conventional rate making guide "just and reasonable", but has provided specific standards peculiarly adapted to the particular commodity.

The exclusion of production and gathering of natural gas from the application of the provisions of the Act is not

qualified so as to apply only to producers who do not also have transportation facilities. The Commission cannot regulate petitioners' production and gathering any more than it can regulate the numerous producers of natural gas and royalty owners who sell their production to petitioners.

It was incumbent on the Commission to determine the field price or actual field value of natural gas in the areas in which petitioners produce their gas, to eliminate petitioners' leaseholds and producing and gathering facilities from the rate base, to disallow expenses of gathering and production—in short, to segregate completely the production phase of petitioners' business from the regulated phase thereof—and to allow to petitioners as an expense item the market price or actual field value for all gas produced by petitioners and taken into their main transmission system.

There was evidence in the record upon which the Commission could have found the market price or field value of petitioners' gas at the well.

Petitioners did not attempt during the hearings to segregate their production and gathering properties and the revenues and expenses related thereto; this was the statutory duty of the Commission. An alternative approach which seemed to lead to substantially the same result was petitioners' contention that, while the operations might all be included within the Commission's rate structure, the rate base valuation of leases and other assets relating solely to production and gathering must be consistent with their legal status as unregulated properties.

The Commission failed to segregate the production and gathering phase of petitioners' business; it included in the rate base all of petitioners' production and gathering facilities and gas leaseholds at only their original cost less reserves for depreciation and depletion. These leaseholds

were carried on petitioners' books at only $955,096, although petitioners offered to prove (but the evidence was excluded) that their leaseholds had a market value of $8,339,722. The exclusion of this evidence was a denial of due process.

The Commission's action in restricting that part of petitioners' earnings derived from their producing and gathering properties to [illegible]½ per cent on the depreciated original cost of such properties was arbitrary, discriminatory, lacking any rational basis, and amounted to a denial of due process for the following further reasons:

1. The prevailing market price or field value of gas at the well in the Hugoton Field was from 4¢ per MCF to 5¢ per MCF and such market price or field value in the Panhandle Field was 4½¢.

2. Petitioners and other gas companies in the Panhandle Field paid their royalty owners 4½¢ per MCF for the ⅛ of the gas produced owned by such royalty owners. These payments to royalty owners were allowed by the Commission as an operating expense without criticism.

3. Petitioners produced approximately fifty per cent of the gas which they transported and sold; the remainder was purchased from royalty owners and numerous independent producers in the field. The average field price paid by petitioners for gas in the year 1940 was 3.8429¢ per MCF. Under the Commission's formula petitioners would have been allowed for the gas which they produced only 2.9924¢ per MCF. Comparable figures for the test year, 1941 (based partly on estimates), were 3.8336¢ per MCF paid by petitioners for purchased gas and 2.8272¢ per MCF allowed petitioners under the Commission's formula for their produced gas. The payments for purchased gas were allowed by the Commission as an operating expense without criticism.

4. With respect to thirty-four wells jointly owned by petitioners and others, petitioners are required to pay 5¢ per MCF for the co-owner's share, but receive only 2.8272¢ per MCF for their share, of the gas coming out of the same well.

5. No separation or segregation was made by the Commission with respect to thirteen producing wells owned by petitioners which were not even connected with petitioners' transmission system but were connected with the gathering system of a local gas company serving local market. Petitioners sold the gas from these wells at the well head at 6.13¢ per MCF. The revenue from these sales for 1941 was $67,365.40. The Commission included all of these sales, and the revenue derived therefrom, in its unit treatment of petitioners' business whereby it determined that $5,094,384 of petitioners' consolidated gross operating revenues for 1941 of $17,789,573 was "available for rate reduction."

ARGUMENT.

I.

THE COMMISSION'S ACTION IN TREATING PETITIONERS' BUSINESS AS AN ENTIRETY AND REFUSING TO MAKE ANY ALLOCATION OR SEPARATION WITH RESPECT TO PETITIONERS' REGULATED AND UNREGULATED SALES WAS BEYOND ITS STATUTORY POWER.

A. The Natural Gas Act excludes direct sales from the rate making powers of the Commission.

Section 1(b) of the Natural Gas Act (Appendix A) specifically provides that the provisions of the Act shall apply to the transportation and sale in interstate commerce of natural gas *for resale* for ultimate public consumption, but *shall not apply* "to any other transportation or sale of natural gas". It necessarily follows that a direct sale to an industrial consumer for such consumer's own use is not subject to the rate making powers of the Commission.

The intent of Congress that such interstate sales should be free of regulation is clearly shown by the legislative history of the Act. The report of the "Hearing before the Sub-Committee of the Committee on Interstate and Foreign Commerce of the House of Representatives" (74th Congress, 2nd session) on H.R. 11662,[9] April, 1936,

[9] The bill that was finally enacted by the Congress as the "Natural Gas Act" was H.R. 6586. In its report to the House (Rep. No. 709, H. Repres., 75th Congress, First Session), the Committee states that the said H.R. 6586 "is substantially identical with H.R. 12680" which, as amended, had been favorably reported by the Committee in the 74th Congress, Second Session. The H.R. 12680, referred to in the said report, contained the following provision as a part of Section 1(b): "Provided, That nothing in this Act shall be construed to authorize the Commission to fix the rates or charges * * * *for the sale of natural gas for industrial use only.*" (Emphasis supplied.) An identical provision was contained in Section 1(b). H.R. 11662.

In the bill, as finally enacted, the exclusion clause is even broader in scope: Sec. 1(b) "*The provisions of this Act* * * * * shall not apply to *any other* transportation or sale of natural gas * * * *." (Emphasis supplied.)

incorporated as a part thereof the brief of Mr. Dozier A. DeVane, then Solicitor for the Federal Power Commission, which brief was submitted to the Committee by Mr. DeVane, at the time of his appearance for the purpose of explaining the various sections of the bill. In speaking of direct sales, Mr. DeVane said in his brief (Page 17 of the said report):

> The bill makes no attempt to regulate the production or gathering facilities of a natural-gas company - - - *Likewise natural gas in the process of transportation in high-pressure mains in interstate commerce for industrial use is excluded upon the basis that such sale is made under highly competitive conditions and is not imbued with a public interest.* (Emphasis supplied.)

When H.R. 6586 (the bill which was enacted as "The Natural Gas Act") was being considered in the House on July 1, 1937, the following colloquy took place:

> Mr. Thompson of Illinois: Is there anything in this bill that would affect the relationship through which the large industrial consumer buys natural gas directly from the pipe line company and not through a local distributing company or agency?
>
> Mr. Lea: The question there involved is whether the purchase is for private consumption, or for resale to the public.
>
> Mr. Thompson of Illinois: It would be for private consumption.
>
> Mr. Lea: If it is for private consumption, it would not be affected by this act; if it were for public consumption, the gas rate would be regulated.
>
> Mr. Thompson of Illinois: There is an industry in my district which I understand buys natural gas directly from the pipe line company and has established its own connection. As I understand, this bill does not purport to regulate such a transaction or existing contracts of that nature.

> Mr. Lea: Not unless it falls within the class of public consumption. A natural gas company engaged in the transportation or sale of gas, as I have just indicated, is subject to regulation under this bill. (Con. Rec., Vol. 81, Part 6, P. 6721.)

Later in the discussion Representative Halleck stated, in explaining the bill:

> The question was asked as to whether or not the price that might be charged to a manufacturer who buys direct from the transportation company would be affected by this bill. As I view it, the answer to that question is that this bill seeks only to reach those sales where the sale is for resale to the ultimate consumer. So a purchaser for industrial use who bought the gas not for resale but for consumption in his own plant, would not be reached by the measure. (Con. Rec., Vol. 81, Part 6, P. 6723.)

It seems clear that Congress recognized that the direct sale of natural gas to industrial plants or for the purchaser's own use is, as Mr. DeVane put it, "not imbued with a public interest". Such plants are served on an interruptible basis and are equipped with stand-by equipment for the use of other fuels. Gas is sold to them on a competitive basis and the price must be in line with the prices of competitive fuels. It is immaterial whether that part of the business of a natural gas company which is not subject to regulation by the Commission, is operated at a loss or at a high profit. The rate making powers of the Commission under Section 5 of the Natural Gas Act (Appendix A) are confined to sales for resale for ultimate public consumption.

B. The Commission failed and refused to observe the statutory limitation on its powers and to make the necessary findings and requisite allocations.

The Commission has recognized its lack of jurisdiction over direct sales in proceedings before it involving other "natural-gas companies" and, in such proceedings, has made allocations supported by specific findings.[10] In the *Cities Service Gas Company* case, 50 P. U. R. (N. S.) 65, 89, the Commission said:

> The Company's facilities and operations are devoted in part to natural gas service which is not subject to our jurisdiction. This service consists principally of gas sales made directly to large industrial customers. The necessity arises, therefore, for making an allocation of costs as between the jurisdictional and non-jurisdictional sales.

The Commission refused, however, in the case at bar, to make any allocation, although the Commission's staff[11] and petitioners[12] presented for the Commission's consideration detailed plans for allocation.

The Commission found that petitioners' consolidated gross operating revenue in 1941 totaled $17,789,573. Treating this consolidated gross revenue as though it were derived entirely from sales for resale, the Commission found that it was $5,094,384 in excess of the consolidated gross revenue which the Commission determined petitioners were entitled to earn. It ordered petitioners to reduce their rates for gas sold for resale so as to reflect in the aggregate a reduction of that amount, but *the impact of the Commission's order was upon petitioners' gross revenue,* which included all of the revenue from petitioners' direct sales. The Commission's formal findings (R. I, 38-43) contain no

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[10] *Cities Service Gas Company*, 50 P. U. R. (N. S.) 65, 89; *Colorado Interstate Gas Company*, 43 P. U. R. (N. S.) 205, 231; *Interstate Natural Gas Company*, 48 P. U. R. (N. S.) 267, 279-280; *Canadian River Gas Co.*, 43 P. U. R. (N. S.) 205, 231; *Cf. Hope Natural Gas Company*, 44 P. U. R. (N. S.) 1, 35.

[11] Commission's witness Shattuck, Ex. 263 (R. XVI, 6883-6887), and explanatory testimony (R. VIII, 3991-4002).

[12] Petitioners' Ex. 251 (R. XIII, 5949-5955) and explanatory testimony (R. VIII, 3631-3676, 3919-3933).

finding of the amount of petitioners' revenue derived from their direct sales or of their property used in such service or of the amount of operating expense attributable thereto. There is no finding of any kind relating to allocation.

The order cannot be sustained upon findings so inadequate, in the face of the undisputed facts that (a) 13.2% of all gas sold was not sold for resale, but for consumption by the purchaser (R. I, 33); (b) $1,500,527 of the gross revenue was derived from such direct sales (R. XIII, 5947); (c) $128,848 of the plant investment was used exclusively in the service of direct industrial customers (R. I, 33); and (d) the entire transmission system from Zionsville, Indiana, to Detroit, Michigan, was used exclusively in the service of customers buying gas for resale (R. VIII, 3616-17, Appendix B).

Although the Commission's findings are silent on the issue presented here, its opinion sets forth its reasons for refusing to make an allocation (R. I, 33-34). Several of the stated reasons, in themselves, show injury to petitioners resulting from the Commission's failure to make an allocation, rather than any sound basis for such failure. None of them finds any basis whatever in the Natural Gas Act. These reasons may be summarized as follows:

> 1. "No capacity has ever been constructed or provided in their gas plant for these direct industrial customers" and only a relatively small investment in plant is used exclusively in the service of the direct industrials;
>
> 2. Deliveries to direct industrial customers are made on an interruptible basis and only when there is available excess off-peak capacity "not required by the other wholesale customers";

3. "Respondents themselves treat their entire business as a unit and make no segregation of costs or profits on their books as between the two classes of sales";

4. The "incidental direct industrial business is in reality a by-product of the wholesale business, comparable to the Respondents' gasoline extraction business".

Examining these reasons in the numerical order stated above, we submit:

1. The facts that no capacity has ever been constructed or provided in petitioners' gas plant for these direct industrial customers and that only a relatively small investment in plant is used exclusively in the service of the direct industrials are material only to the extent that they show the relatively small proportion of the expense of construction and operation of the properties which should be allocated to the direct industrial sales. If the Commission has no jurisdiction over these sales, it cannot deal with them as regulated sales, regardless of the comparative volume, the relatively small investment in properties exclusively used in such service, or the predominant use in the regulated business of the jointly used properties.

2. The fact that petitioners' direct sales to industrial customers are made on an interruptible basis and are almost completely curtailed on peak days, when substantially the entire capacity of the line is required for the service of regulated sales, emphasizes the relatively small amount of the cost of construction and operation attributable to such sales. It does not in any way support a failure to allocate. The interruptible nature of such sales was well known to Congress at the time the Natural Gas Act was being considered (see discussion of legislative history, *supra*, pages 19-21). With this knowledge, Congress excluded such sales from the rate making powers of the Commission and, thus, established the necessity of allocation.

3. The Commission's jurisdiction with respect to rate making cannot be enlarged by any waiver on the part of petitioners. An intent to waive their statutory right to have their exempted sales free from regulation cannot be inferred, however, from the manner in which their books were kept. There is no showing that petitioners' books were not kept in accordance with the rules and regulations prescribed by the Commission. Furthermore, the record shows that sufficient evidence upon which to make a separation or allocation was before the Commission.

4. The Commission's statement that the "direct industrial business is in reality a by-product of the wholesale business, comparable to the respondents' gasoline extraction business" has no support in reason or in fact. The extraction of gasoline and water from the natural gas as it comes from the well is absolutely necessary in order that the gas can be safely and economically transported. The extracted gasoline may be termed a by-product. The gas sold to the consumer directly rather than through a distributing company, is not in any sense a by-product. It is the same commodity that is sold to distributing companies for resale. The distinction between the direct sale and the sale for resale created by the Natural Gas Act is artificial. The basis for the distinction is found in the legislative history of the Natural Gas Act (*supra,* pages 19-21). Congress recognized that such sales are governed by competitive conditions, that they are "not imbued with a public interest", and that they form an important segment of the natural gas industry. Such sales were exempted from the rate making powers of the Commission.

The Commission characterized the direct sales as "purely incidental" (although the record shows that petitioners, from the outset, have sought, and obtained, direct sales as well as sales for resale (Ex. 179, R. XII, 5457); referred to some remarks of Panhandle Eastern's President to the effect that allocation of cost of service, including "return",

was "theoretical", "unrealistic" and "not practical" (comments, clearly, lending no legal support to the Commission's failure to make an allocation); and concluded its discussion of the subject with the statement (R. I, 34):

> It is obvious from the record that respondents have made no clear and convincing showing that the direct industrial sales are so distinct and separate from the general wholesale business that the two cannot here be considered together. We conclude, therefore, that, under such circumstances, it is not unreasonable to treat the entire business as a unit requiring no allocation as between the two classes of sales.

This statement shows that the Commission fell into error in two further respects—(1), in assuming that any such burden was placed upon petitioners by the statute, and (2) in assuming that the statute conferred upon the Commission authority to include, or segregate, petitioners' non-regulated business, according to its judgment of what would be reasonable under the circumstances.

As to the first of these errors, the natural Gas Act places no burden upon petitioners to make "a clear and convincing showing that the direct industrial sales are so distinct and separate from the general wholesale business that the two cannot here be considered together" (such a showing, however, was actually made). The duty was heavy upon the Commission to refrain from exercising jurisdiction over a subject matter expressly excluded from its authority. The flagrance of its disregard of this duty is emphasized by the fact that its own staff submitted a plan for separating the non-regulated from the regulated.

As to the second of these errors, we know of no authority for the proposition that an administrative agency may knowingly regulate within a field expressly excluded from its jurisdiction by the source of its authority; simply be-

cause it appears reasonable to do so.[13] The courts have always been alert to inquire *sua sponte* into questions affecting their jurisdiction. Where it appears that the subject matter is expressly excluded from the court's jurisdiction, no waiver or other action of the parties can confer such jurisdiction.[14] Administrative agencies should be equally alert.

It is not responsive to the issue for respondents to say, as they did at page twelve of their brief in opposition to the petition for certiorari herein:

> The Commission's finding that it was unnecessary in this case to make a detailed allocation was accordingly supported by substantial evidence and cannot be said to lack a rational basis.

The substantial evidence rule may be invoked only *after* jurisdiction is established. The question is whether the Commission exceeded the statutory limitation upon its powers. "Only when the statutory standards have been applied can the question be reached as to whether the findings are supported by evidence."[15] The plain fact is that the Commission exceeded its jurisdiction. In determining the amount of the rate reduction ordered, the Commission failed to separate transactions which were within its jurisdiction and those which were beyond its jurisdiction. Its order was based upon inadequate findings. The findings rested upon the theory that petitioners' *entire* business was subject to the jurisdiction of the Commission (R. I, 38, 42):

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[13] *Cf. Federal Trade Comm. v. Bunte Bros., Inc.*, 312 U. S. 349; *Smith v. Illinois Bell Tel. Co.*, 282 U. S. 133, 148-150; and *Mitchell v. United States, et al.*, 313 U. S. 80, 97.

[14] *Cutler v. Rae*, 7 How. 729, 730; *United States v. Corrick*, 298 U. S. 435, 440.

[15] *United States, et al. v. Carolina Freight Carriers Corp.*, 315 U. S. 475, 489.

whereas a substantial part thereof was expressly excluded by the Act. As a result, there is a "congenital infirmity" in the order, which renders it void and unenforceable.

In *United States et al.* v. *Baltimore & Ohio Railroad Co.*, 293 U. S. 454, an order of the Interstate Commerce Commission was under attack. Mr. Justice Brandeis, speaking for a unanimous court, said (page 462):

> The railroads contend that to support the order certain basic findings are essential; that these were not made; and that, hence, the order is void. This contention is in our opinion sound.

And further (page 464):

> This complete absence of "the basic or essential findings required to support the Commission's order" renders it void. *Florida* v. *United States*, 282 U. S. 194, 215. Compare *Wichita Railroad & Light Co.* v. *Public Utilities Comm'n*, 260 U. S. 48, 58-59; *Mahler* v. *Eby*, 264 U. S. 32, 44-45.

In *United States, et al.* v. *Carolina Freight Carriers Corp.*, 315 U. S. 475, an order of the Interstate Commerce Commission made under the provisions of the Motor Carrier Act of 1935 was under attack. Mr. Justice Douglas said (pages 488-489):

> It is impossible to say that the standards which we have set forth were applied to the facts in this record. Hence, as in *Florida* v. *United States*, 282 U. S 194, 215, the defect is not merely one of the absence of a "suitably complete statement" of the reasons for the decision; it is the "lack of the basic or essential findings required to support the Commission's order." And see *United States* v. *Baltimore & Ohio R. Co.*, 293 U. S. 454, 464; *United States* v. *Chicago, M. St. P. & P. R. Co.*, 294 U. S. 499, 510-511. Congress has made a grant of rights to carriers such as appellee. Congress

has prescribed statutory standards pursuant to which those rights are to be determined. Neither the Court nor the Commission is warranted in departing from those standards because of any doubts which may exist as to the wisdom of following the course which Congress has chosen. Congress has also provided for judicial review as an additional assurance that its policies be executed. That review certainly entails an inquiry as to whether the Commission has employed those statutory standards. If that inquiry is halted at the threshold by reason of the fact that it is impossible to say whether or not those standards have been applied, then that review has indeed become a perfunctory process. *If, as seems likely here, an erroneous statutory construction lies hidden in vague findings, then statutory rights will be whittled away.* An insistence upon the findings which Congress has made basic and essential to the Commission's action is no intrusion into the administrative domain. It is no more and no less than an insistence upon the observation of those standards which Congress has made "prerequisite to the operation of its statutory command." *Opp Cotton Mills, Inc. v. Administrator,* 312 U. S. 126, 144. Hence the requirement is not a mere formal one. *Only when the statutory standards have been applied can the question be reached as to whether the findings are supported by evidence.* (Emphasis supplied.)

C. The Court below erred in holding that no allocation was required.

The court below examined the method of allocation submitted by the Commission's staff and the method of allocation submitted by petitioners' witnesses, made its own calculation (predicated upon a misapprehension of what the testimony and computations of the witnesses showed) and concluded (R. XVI, 7212):

There is in the record a substantial basis for the Commission's conclusion that, in determining reasonable rates for sales of natural gas subject to

regulation, it was unnecessary to make a segregation of revenues attributable to sales not subject to regulation, and that, if a segregation had been made, it would not materially have affected the result.

In its calculation, the court below had to charge the direct sales *twice* with the same item, $500,414, in order to reach its conclusion that "if a segregation had been made, it would not materially have affected the result". It had to treat the entire $1,000,828, net revenue from direct sales, as revenue from sales for resale by, first, *contributing* $500,414 to the "return" and, second, regarding the remaining $500,414 as being *in* the "return".

Upon analysis of the opinion of the court below, two erroneous conceptions appear to be primarily responsible for the result reached, namely, (1) its conception that petitioners' witness Biddison's "businessman's judgment" had the same legal force as a finding and determination by the Commission, and (2) its conception of the meaning and effect of the term "return", as used in the method of allocation which the witness was pursuing from his understanding of the Commission's prior opinion in the Colorado Interstate case.[16]

Discussing these in order, we submit:

1. Exhibit 251 (R. XIII, 5947), on which Biddison's testimony was based, purported to be only his determination of a proper segregation of revenues and a proper allocation of operating expenses between regulated and non-regulated sales in accordance with the method Biddison understood the Commission had adopted in the Colorado Interstate case. The exhibit showed that, after such allocation, including Federal income taxes in the amount of $349,062.28, the sum of $651,766.70 remained as earnings

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[16] In re: Colorado Interstate Gas Co., 43 P.U.R. (N.S.) 295; now under review in this Court, No. 379, October term, 1944.

from direct sales. This sum, plus the item of $349,062.28, representing Federal income taxes, totalled $1,000,828, and this is the source from which the court below obtained that figure.

Biddison was unwilling to go further with the allocation. When he was pressed by counsel for the Commission as to what "some fair basis" of allocation beyond this would be, he said (R. VIII, 3873):

> I do not think I should be sitting in the judge's bench on that matter. Before anybody could make a definite statement about what he thought was fair on that matter, he would have to know what the procedure was going to be in regard to the subsequent allocation of earnings between the two classes of business. * * *
>
> In the subsequent procedure in this case of allocating *return as if it were an item of cost,* one should know that and then, knowing that, I think that some compromise could be reached between whether the whole million dollars should be retained or what amount of it should be charged as a rental and credited to the regulated business *as a reduction in expense.* (Emphasis supplied.)

Previously, Biddison had been asked: "Is there any engineering basis for a division, from an engineering standpoint?" He had replied:

> Not as an engineering matter. I do not know of any basis. As a business matter I think there are ways in which it could be fairly decided (R. VIII, 3872).

When pressed by the trial examiner for his judgment on the matter, he said:

> If the examiner wants my opinion, I will give it. It is my opinion that the $1,000,828.98 should be divided 50-50.

The examiner asked, "Why?" and Biddison said:

> It is my judgment. It is just my judgment as a businessman, that would be a fair allocation of it (R. VIII, 3874).

This is the evidence upon which the court below held:

> The record indicates that the 1941 revenue of petitioners from direct industrial sales less expenses, but before Federal income taxes, was $1,000,828; that a fair allocation of this revenue would be to treat one-half of it as derived from direct sales; and that the net amount properly attributable to that nonregulated portion of the business would be $319,656 ($500,414 return less $180,758 income taxes at 1941 tax rates) (R. XVI, 7211, 7212).

We shall demonstrate presently the fallacy of this conclusion. We make the point here that the court below committed a fundamental error in its conception that the "businessman's judgment" of Biddison had the same legal effect as a finding thereon by the Commission. As the witness himself stated, he was not "sitting in the judge's bench on that matter".

2. The court's conception of the meaning of the word "return" as used by the witness Biddison (according to his understanding of the method of allocation applied by the Commission in the Colorado Interstate case) was clearly erroneous. The term "return", as so used, is regarded as an item of cost but is, in effect, the earning which the Commission allows the regulated company, as the owner of the properties, for the use of such properties in the regulated portion of its business.

Although, in the course of examination by different counsel, the witness referred to his "50-50" allocation as mak-

ing a "contribution" to the regulated business and as a "fee" for the privilege of using the equipment and as a "rental credited to the regulated business", he definitely stated that, if his suggestion were adopted by the Commission, whatever amount were "contributed" would go to *return and depreciation.* He said (R. VIII, 3857):

> If you take some of the profits from the non-regulated business and credit to the costs of the other business considered as a rental charge for the privilege of using the facilities, you can consider that it has contributed *to return and to depreciation.* (Emphasis supplied.)

Thus, when Biddison suggested a "contribution", "fee", or "rental" of $500,414 as a fair payment by the direct sales for the use of the properties, he clearly meant that it would be a part of the *return* eventually allowed by the Commission. Nowhere in the record is there any testimony that a fair allocation of the net revenue from direct sales of $1,000,828 "would be to treat one-half of it as derived from direct sales". It is apparent, therefore, that, when the court below made the computation by which it arrived at the conclusion that an allocation would yield petitioners only $319,656 net earnings, after taxes, on their direct sales, it misconceived the effect of Biddison's suggested contribution of $500,414 *to return.*

Adopting Biddison's suggested formula and his "businessman's judgment" of a reasonable contribution, "to depreciation and return", we find that petitioners were deprived of at least $319,656 net earnings after taxes, over and above return, by the Commission's failure to make an allocation. This is demonstrated by the following computations:

Gross revenue from direct sales (Ex. 251, R. XIII, 5947, L. 23, Col. F)	$1,500,527
Operating expenses, depreciation, etc., allocable to direct sales (R. XIII, 5947, lines 25 to 36, Col. F)	$ 499,699
Available for income tax, return, and excess earnings	$1,000,828
Contribution to depreciation and return	$ 500,414
Available as excess earnings (above return) ...	$ 500,414
Federal income taxes on $500,414 (in the percentage of taxes shown on the books which the $500,414 bears to total earnings)	$ 180,758
Earnings on direct sales *in excess* of amount included in return (on entire business) after expenses of operation, taxes and contribution to depreciation *and return*	$ 319,656

The court below also misinterpreted the testimony of the Commission's witness Shattuck, who had a different approach to the problem of allocation. The court below said (R. XVI, 7212):

> Under the Commission's order, the petitioners are allowed a 6½% return ($4,363,925) on their entire business. Under the method of allocation proposed by an expert witness of the Commission, $4,017,878 of the return would be attributable to sales at wholesale (subject to regulation), and $346,047 to direct industrial sales (not subject to regulation).

Shattuck allocated to direct sales all charges of every kind which he thought should be borne by such sales, including Federal income taxes, and arrived at a total figure of $823,922. His testimony and exhibit (Ex. 263. R. XVI, 6883) stopped at this point. He regarded "return" as an item of "cost of service" and said he could go no further with his allocation until the Commission had determined

the "return". He stated, however, the method he would use if he knew what the amount of return would be (R. VIII, 4002).

If we adopt his method, we find that, after his total costs allocated to direct sales, $823,922, are deducted from the undisputed amount of gross revenue from direct sales, $1,500,527, the company earned on its direct sales the sum of $676,605. If we subtract from this amount the $346,047 which the court below found was the amount which the order permitted as an earning on direct sales, we find that the Commission's failure to make an allocation deprived petitioners of earnings in the amount of at least $330,558 per year on their sales not subject to regulation. This is demonstrated by the following computation:

Gross revenue from direct sales (Ex. 251, R. XIII, 5947, L. 23, Col. F)	$1,500,527
Total expenses, depreciation, and taxes allocated by Shattuck to direct sales (Ex. 263, L. 5, Col. E, R. XVI, 6883)	$ 823,922
Net earnings from direct sales	$ 676,605
Amount of 6½% return allocated to direct sales by the court below, *not by the Commission or by any witness*	$ 346,047
Net earnings from direct sales over and above expenses of operation, depreciation, taxes, and share of 6½% return	$ 330,558

Pursuing another approach, it appears that the Commission's failure to make appropriate findings and allocations deprived petitioners of at least $330,982 per year net revenue from direct sales after all expenses, share in permitted return, and taxes.

In Shattuck's exhibit 263 (R. XVI, 6883), he allocated to direct sales, a total operating expense of $823,922. This includes an allocation of depreciation, taxes (including Federal income taxes) and all other operating revenue deductions, but does not include return on investment. The allocation of $823,922 represents 7.92% of the entire allocated expenses of $10,399,651. Applying that same percentage to the permitted return ($4,363,925), that portion of the so-called "return" allocated to direct sales would be $345,623, which, added to the operating cost of $823,922, would result in a total "cost", including return, taxes, and depreciation, of $1,169,545. Subtracting that cost from the item of $1,500,527, the net earnings from direct sales to which Petitioners are entitled *over and above return*, is found to be $330,982.

The necessity of making findings and allocations to avoid injury to the petitioners can likewise be illustrated by still another approach:

It is uncontradicted that the gross revenue from the direct sales was $1,500,527.89. Biddison found that the operating cost allocable to these sales was $499,698.91, leaving, before taxes, $1,000,828.98 (R. VIII, 3872). Shattuck's estimate of cost attributable to direct sales, excluding taxes, would indicate an operating expense of $539,384.16 and a net, before taxes, of $960,143.03. Thus, it is clear that petitioners had, before taxes, operating profits from their direct sales of at least $960,143.03, which should have been set apart as unregulated revenue; whereas, the Commission, in fact, blanketed the whole of this revenue into its unit consideration of petitioners' business in arriving at the figure of $5,094,384 found to be "available for rate reduction".

We do not concede that the Commission's "cost of service" method of allocation (now under review by this Court

in number 379 October term, 1944), which Biddison and Shattuck attempted to follow; is a valid substitute for a proper separation of property according to its use. The conclusions and calculations of these witnesses have been discussed in order to demonstrate the fallacy in the reasoning of the court below and also to illustrate that allocations could have been made by the Commission, and that its failure to make appropriate findings and allocations worked a substantial injury to petitioners.

The exact injury is not reflected in the record and is impossible of definite determination in the absence of the required findings by the Commission. That injury did result from the Commission's failure to discharge its statutory duty is clear, however, and is emphasized by certain additional facts:

In the Hugoton Field in Kansas, Panhandle Eastern owned a particular group of thirteen producing wells, the gas from which was sold to Argus Natural Gas Company, operating in Kansas. The wells were not even physically connected with any part of petitioners' transmission system but were connected with the gathering system of Argus Natural Gas Company (R. I, 255-256; XIII, 5893; IX, 4133). This part of petitioners' business was beyond the jurisdiction of the Commission under Section 1(b) of the Natural Gas Act, not only because of its intrastate character, but also because it was essentially production.

The revenue derived from the sales of gas from the thirteen wells to the Argus Natural Gas Company, $67,-365.40 for the year 1941 (R. XIII, 5707) was all included in the Commission's unit consideration of petitioners' entire business in determining the amounts which should be retained by the petitioners in the form of net revenue available for its 6½ per cent return upon the allowed rate base.

The Commission made no findings addressed to the evidence bearing on allocation examined by the court below; it made no segregation or any findings showing what the result of a segregation, if made, would be; and it made no findings in support of the conclusion (imputed to it by the court below (R. XVI, 7212) but not found in the opinion or findings of the Commission) that, "if a segregation had been made, it would not materially have affected the result".

Furthermore, the court below completely ignored the fact that, in arriving at their respective estimates of "cost of service" allocable to the unregulated sales, both the witness for the Commission's staff and the witness for petitioners had made *pragmatic adjustments* which were not reviewed by the Commission, and *upon which the Commission had made no findings whatever*. The absence of this essential element of the legislative process delegated to the administrative body appears to have been completely overlooked by the court below. The majority opinion held (R. XVI, 7212) that:

> * * * a failure of the Commission to give proper effect to that fact [the fact that the revenues of the company derived from direct sales to customers are not subject to regulation] unless arbitrary or capricious, does not, we think, deprive the Commission of its jurisdiction to make a rate order with respect to sales which are subject to regulation.

Judge Riddick, dissenting, expressed the view (R. XVI, 7218) that:

> In this situation it seems to me idle to inquire whether the Commission's order, call it a "pragmatic adjustment" or what-not, does or does not result in confiscation of petitioners' property or whether it is less or more favorable to petitioners than would have been the case had the Commission confined itself to its per-

mitted field. It is enough to require a remand of this proceeding that the Commission has exceeded the statutory limitation on its powers.

We submit that Judge Riddick was clearly correct and that the holding of the majority was error. The decisions of this court are uniform in holding that, where part of a regulated business is not subject to regulation, the regulatory body must make an appropriate separation or allocation of property, revenue, and expense as between the regulated and non-regulated transactions.[17]

The rule was stated in the *Minnesota Rate Cases*, 230 U. S. 352, 435, as follows:

> Where the business of the carrier is both interstate and intrastate, the question whether a scheme of maximum rates fixed by the state for intrastate transportation affords a fair return *must be determined by considering separately the value of the property employed in the intrastate business* and the compensation allowed in that business under the rates prescribed. This was also ruled in the Smyth Case (id. p. 541). The reason, as there stated, is that the state cannot justify unreasonably low rates for domestic transportation, considered alone, upon the ground that the carrier is earning large profits on its interstate business, and, on the other hand, the carrier cannot justify unreasonably high rates on domestic business because only in that way is it able to meet losses on its interstate business. * * *

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[17] *Smith* v. *Illinois Bell Telephone Co.*, 282 U. S. 133, 150;

Minnesota Rate Cases (Simpson v. *Shepard)*, 230 U. S. 352, 435, 437;

Banton v. *Belt Line Ry. Corp.*, 268 U. S. 413, 421;

Northern Pacific Railway Co. v. *McCue*, 236 U. S. 585, 596-597;

United Fuel Gas Co. v. *Railroad Commission*, 278 U. S. 300, 319;

Northern Pacific Rwy. v. *Dept. Public Works*, 268 U. S. 39, 43-44.

> When rates are in controversy, it would seem to be *necessary* to find a basis for a division of the total value of the property independently of revenue, and this must be found in the use that is made of the property. That is, there should be assigned to each business that proportion of the total value of the property which will correspond to the extent of its employment in that business. (Emphasis supplied.)

In *Smith* v. *Illinois Bell Telephone Company,* 282 U. S. 133, property of the company was used both for intrastate and interstate business. This Court said (pp. 147, 149):

> At the threshold of the discussion, we are met with the fact that, in these findings, the commission and the court made no distinction between the intrastate and the interstate property and business of the company. It appears that the property of the company in Chicago is used to render (1) what is called exchange service, all of which is intrastate, (2) intrastate toll service over its own lines and under arrangements with companies other than the American Company, and (3) interstate toll service, which includes all the toll service rendered under arrangements with the American Company. The company introduced evidence separating the intrastate and interstate business and also the intrastate exchange business. While the court regarded these computations as correct, and approved the method in which they had been made, still *the court made no specific findings* based on a separation of the intrastate and interstate property, revenues and expenses, but determined the issue on the basis of the total Chicago property of the company.
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> * * * * *
>
> The separation of the intrastate and interstate property, revenues and expenses of the company is important not simply as a theoretical allocation to two branches of the business. *It is essential* to the appropriate recognition of the competent governmental authority in each field of regulation. * * * The proper

regulation of rates can be had only by maintaining the limits of state and federal jurisdiction, and this can not be accomplished unless there are findings of fact underlying the conclusions reached with respect to the exercise of each authority. In view of the questions presented in this case, the validity of the order of the state commission can be suitably tested only by an appropriate determination of the value of the property employed in the intrastate business and of the compensation receivable for the intrastate service under the rates prescribed. * * * As to the value of that property, and as to the revenue and expenses incident to that business, separately considered, *there should be specific findings. Railroad Commission* v. *Maxcy*, 281 U. S. 82, 83, 74 L. Ed. 717, 718, 50 S. Ct. 228. (Emphasis supplied.)

In *Banton* v. *Belt Line Railway Corp.*, 268 U. S. 413, the Court was considering an order of the New York Public Service Commission establishing maximum joint fares on street railways in New York City, of which appellee formed a part. It alleged that the order deprived it of any return on the fair value of its property used to perform the service covered by the joint fare. On the question of allocation, this Court said (page 421):

There is involved only the rates applicable to a part of the company's business. In this respect, the case is similar to *Northern Pacific Railway* v. *North Dakota*, 236 U. S. 585; *Norfolk & Western Ry.* v. *West Virginia*, 236 U. S. 605, and *Northern Pacific Railway* v. *Department of Public Works of Washington*, 268 U. S. 39. The applicable law is plain. The State is without power to require the traffic covered by the fare enjoined to be carried at a loss or without substantial compensation over its proper cost. And such cost includes not only the expenditures, if any, incurred exclusively for that traffic, but also a just proportion of the expenses incurred for all traffic of which that in question forms a part. The

cost of doing such business is not, and properly cannot be, limited to the amount by which total operating expenses would be diminished by the elimination of, or increased by adding, the transfer passengers in question. It would be arbitrary and unjust to charge to that class of business only the amount by which the operating expenses were, or would be, increased by adding that to the other traffic carried. Outlays are none the less attributable to transfer passengers because also applicable to other traffic. Operating expenses which are incurred on account of all passengers carried, and which are not capable of direct allocation to any class, should be attributed to the transfer passengers in question in like proportion as such expenses are fairly chargeable to other passengers receiving like service.

In *United Fuel Gas Co. v. Railroad Commission of Kentucky*, 278 U. S. 300, a final decree of the District Court denying an injunction restraining the Railroad Commission from enforcing rates for natural gas in certain communities in Kentucky was under review. In considering the treatment of certain facilities of the gas company which were used jointly in the regulated business of distributing gas to consumers and in the unregulated business of extracting gasoline from the natural gas, this Court said (pages 319-320):

In the process of extracting gasoline from natural gas, the gas flows from the field to the extraction plant, where the gasoline is taken out, the residual gas being returned to the transmission system for distribution to consumers. In the production of this gasoline, therefore, joint use is made of the gas, gas field and certain facilities of the gas company. This joint use requires a prorating of joint investment and expenses and of the return from the joint enterprise.

D. The order of the Commission should be set aside.

The failure of the Commission to make the necessary separation of property, revenue, and expenses as between the sales subject to regulation and the sales not subject to regulation renders its order null and void; under the provisions of the Natural Gas Act, the order should be set aside. Although Section 19(b) of the Natural Gas Act (Appendix A) provides that, upon review, the Court may modify an order of the Commission, relief to petitioners by modification of the order is impossible here because the legislative process is incomplete and forms no adequate basis upon which the Court can modify the order without departing from the judicial function and performing the legislative function.

The necessary separation, segregation or allocation requires, not only an examination of the record and the weighing of the ultimate facts shown by the evidence introduced by the Commission's staff and by petitioners on the subject of allocation, but also requires a careful examination of the numerous pragmatic adjustments and allocations made by the witnesses with respect to items of property, revenue, and expense. These were made purely on the judgment of the witnesses as to what would be fair and equitable under the circumstances. Where there is a conflict in the judgment of the witnesses, such conflict must be resolved. Where there is no conflict, the appropriateness of the result must still be reviewed. If the Commission finds that an appropriate allocation is not presented by the witnesses, it is still under a duty to make findings and appropriate allocations.[18]

These are matters requiring expertise, forming part of the legislative process which Congress has delegated to the Federal Power Commission. They are part of the rate

[18] See argument supra, pages 27-29, 39-42.

making function. The function of the court with respect thereto can be performed only after the administrative body has examined and weighed *all of the pertinent evidence* and made adequate findings.[19]

In *Newton v. Consolidated Gas Co.*, 258 U. S. 165, this Court said (Page 177):

> Rate making is no function of the courts and should not be attempted either directly or indirectly.

In *Keller v. Potomac Electric Co.*, 261 U. S. 428, the Court was considering the Public Utilities Law of the District of Columbia, which established a commission and provided that any person dissatisfied with an order of the Commission "may commence a proceeding in equity in the Supreme Court of the District of Columbia * * * to vacate, set aside or modify any such decision" and that the same should be tried "as are equity proceedings in said court." Mr. Chief Justice Taft said (pages 440-441):

> What is the nature of the power thus conferred on the District Supreme Court? Is it judicial or is it legislative? Is the court to pass solely on questions of law, and look to the facts only to decide what are the questions of law really arising, or to consider whether there

[19] *Terminal Railroad Asso. of St. Louis v. United States, et al.* 266 U. S. 17, 30;
Keller v. Potomac Electric Co., 261 U. S. 428;
Ohio Valley v. Ben Avon Borough, 253 U. S. 287, 289;
Louisville & Nashville R. R. Co. v. Garrett, 231 U. S. 298;
Prentis v. Atlantic Coast Line Co., 211 U. S. 210, 226;
Texas & Pacific Railroad v. Abilene Cotton Oil Co., 204 U. S. 426, 440;
Robinson v. B. & O. R. R. Co., 222 U. S. 506;
Skinner & Eddy Corp. v. United States, 249 U. S. 557;
United States v. Abilene & Southern Railroad Co., 265 U. S. 274;
O'Donoghue v. United States, 289 U. S. 516;
Newton v. Consolidated Gas Co., 258 U. S. 165;
Interstate Commerce Commission v. Inland Waterways Corp.,

was any showing of facts before the Commission upon which, as a matter of law, its finding can be justified? Or has it the power, in this equitable proceeding to review the exercise of discretion by the Commission and itself raise or lower valuations, rates, or restrict or expand orders as to service? Has it the power to make the order the Commission should have made? If it has, then the court is to exercise legislative power in that it will be laying down new rules, to change present conditions and to guide future action and is not confined to definition and protection of existing rights. In *Prentis* v. *Atlantic Coast Line Co.*, 211 U. S. 210, 226, we said:

"A judicial inquiry investigates, declares and enforces liabilities as they stand on present or past facts and under laws supposed already to exist. That is its purpose and end. Legislation on the other hand looks to the future and changes existing conditions by making a new rule to be applied thereafter to all or some part of those subject to its power. The establishment of a rate is the making of a rule for the future, and therefore is an act legislative not judicial in kind. . ."

In *Interstate Commerce Commission* v. *Inland Waterways Corp.*, 319 U. S. 671, Mr. Justice Jackson said (pages 691-692):

Our function does not permit us either to prescribe or approve rates, and our decision carries no implication or approval of any rates here involved. Nor are we at liberty to prescribe general attitudes the Commission must adopt towards the exercise of discretion left to it rather than to courts. We decide only whether the Commission has acted within the power delegated to it by law,

II.

THE COMMISSION CANNOT, CONSISTENTLY WITH THE NATURAL GAS ACT AND WITH DUE PROCESS OF LAW, RESTRICT THAT PART OF PETITIONERS' EARNINGS DERIVED FROM THEIR PRODUCING AND GATHERING PROPERTIES TO 6½ PER CENT ON THE DEPRECIATED ORIGINAL COST OF SUCH PROPERTIES.

By Section 1(b)[20] of the Act, Congress expressly provided that the provisions of the Act *shall not apply to the production or gathering of natural gas.* The same section provides that the Act shall apply to "the sale in interstate commerce of natural gas for resale * * *." Considering the latter clause in isolation, it might appear that the Commission has jurisdiction to fix the price which the producer of gas is entitled to receive, after he has reduced the gas to possession, where he sells for interstate transportation and resale.

When, however, the provisions of Sections 1(b) are considered together and in their relation to the whole scheme of regulation, particularly the declared policy set forth in Section 1(a) of the Act, the conclusion is inescapable that the intent of Congress was to exclude from regulation the entire business of production and gathering, including the interstate sale of gas by the producer thereof even though it could constitutionally regulate such sale; likewise, to exclude from regulation the production and gathering phase of the business of a "natural-gas company" engaged in interstate transportation and sale.

Section 1(a) declares that "the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest." Thus, it is the

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[20] Appendix A.

service of transporting gas to the interstate markets that Congress declares to be imbued with a public interest and to require regulation. There is nothing in the Act or in its legislative history indicating that Congress found that the prices of natural gas prevailing at the points of production were exorbitant or that the public interest required federal regulation of such prices.

Where Congress has authorized price fixing with respect to *a commodity*, as distinguished from *a service*, it has not delegated to the administrative agency freedom of action within the broad limits of the conventional rate-making guide "just and reasonable", but has provided specific standards peculiarly adapted to the particular commodity.[21]

In excluding production and gathering from the application of the provisions of the Act, Congress might well have had in mind the peculiar nature of this phase of the natural gas business. Mr. Justice Jackson said, in his dissenting opinion in the *Hope* case, that this phase of the business is "more erratic and irregular and unpredictable in relation to investment than any phase of any other utility business * * * Gas itself is tangible, possessible, and does have a market and a price in the field" (320 U. S. 591, 647). He recognized that the value of gas reserves lies in discovery, possibility of discovery and market, and that this value has little, if any, relationship to the ordinary rate case concept of rates or prices for services rendered by means of replaceable property.

The exclusion of production and gathering of natural gas from the application of the provisions of the Act is not qualified so as to apply only to producers who do not also have transportation facilities. The Commission can no

[21] Cf. Agricultural Marketing Agreement Act of 1937, 7 U.S.C., Sections 608c et seq.

Bituminous Coal Act of 1937, 15 U.S.C., Sections 828 et seq.

more regulate petitioners' production and gathering than it can regulate the numerous producers of natural gas who sell their production to petitioners.[22]

It was incumbent on the Commission to determine the field price or actual field value of natural gas in the areas in which petitioners produce their gas, to eliminate petitioners' leaseholds and producing and gathering facilities from the rate base, to disallow expenses of gathering and production—in short, to segregate completely the production phase of petitioners' business from the regulated phase thereof[23]—and to allow to petitioners as an expense item the market price or actual field value for all gas produced by petitioners and taken into their main transmission system.

There was evidence in the record upon which the Commission could have found the market price or field value of petitioners' gas at the well. It was stipulated that in the Hugoton field, Panhandle Eastern was purchasing from numerous companies at 4¢, from others at 4½¢ and from still others at 5¢ per MFC (R. III, 1107). It was shown that, in the Panhandle field, Panhandle Eastern had certain gas purchase contracts at prices less than 4¢ per MCF. The witness, Biddison, said these contracts had a value to Panhandle Eastern in excess of $1,500,000, because they were long time contracts, made when low field prices existed, at purchase prices of 2½¢ and 3½¢ per MCF (R. III, 1095-1098), whereas, in his opinion, 4½¢ represented the general field price for high pressure sweet gas at the wells (R. III, 1099) and 4½¢ was "a fair measure of its present well head value" (R. III, 1101).

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22 Petitioners purchase approximately fifty per cent of the gas they transport (R. IX, 4155), under contracts which are for the life of the production. Therefore, the reserves of natural gas of these producers are effectively dedicated to petitioners' system.

23 Cf. *Smith* v. *Illinois Bell Telephone Co.*, 282 U. S. 133, 148-150.

It was further shown by this witness that Panhandle Eastern and other gas companies were then paying their royalty owners in the Panhandle field on a basis of $4\frac{1}{2}$¢ per MCF; that the royalty provision was ordinarily for $\frac{1}{8}$th of the product and that "compensation is generally made in cash at what is construed to be the value per unit of the amount of royalty gas * * * produced" (R. III, 1100-1101). The average unit price paid by Panhandle Eastern to its royalty owners during the year 1941 was approximately 4.5¢ per MCF for their $\frac{1}{8}$th of the gas produced. The total volume of gas produced during the year was 30,059,021 MCF (R. XIII, 5713). One-eighth of that volume, 3,757,377 MCF, represented the interest of the royalty owners in such production. For that royalty interest petitioners paid their royalty owners $171,043.82 (R. XIII, 5679). This was an average of 4.5¢ per MCF. These payments to royalty owners were allowed by the Commission, as an operating expense, without criticism.

Petitioners did not attempt during the hearings to segregate their production and gathering properties and the revenues and expenses related thereto; this was the statutory duty of the Commission. An alternative approach which seemed to lead to substantially the same result (see *infra* pages 53-54) was petitioners' contention that, while the operations might all be included within the Commission's rate structure, the rate base valuation of leases and other assets relating solely to production and gathering must be consistent with their legal status as unregulated properties.

But the Commission ignored its statutory duty and made no attempt to segregate petitioners' production and gathering facilities, or to determine separately the value of the gas and a reasonable allowance for transportation thereof. It chose the easier, though unwarranted, course of treating petitioners' properties, regulated and unregu-

lated, as one inseparable unit. It not only failed to segregate the production and gathering phase of petitioners' business, but it actually included in the rate base all of petitioners' production and gathering facilities and gas leaseholds at only their original cost less reserves for depreciation and depletion. These leaseholds were carried on petitioners' books at only $955,096, although petitioners were prepared to show, and offered to prove, that those leaseholds had a market value on June 1, 1941, of $8,339,722.

The Commission's action in the case at bar in assuming jurisdiction over matters excluded from the application of the provisions of the Natural Gas Act was based on an erroneous concept of its powers under the Act. The order is, moreover, peculiarly subject to attack in these proceedings as a denial of due process because the Commission, through its trial examiner, excluded evidence which was admissible in reaching a determination with respect to the value of petitioners' gas leaseholds and also the value of the commodity in the fields where produced.

The excluded evidence was tendered through a witness of many years' experience in the Panhandle and Hugoton fields. During this experience he had bought and sold many leases, both on his own behalf and as broker. He was not in any way connected with petitioners. His analysis of the market value was based on a knowledge of the locations of the various wells and an examination of each of the leases. He took into consideration the unitization agreements which Panhandle Eastern had obtained from its lessors, the subjection to outside drainage, the productivity of each drilled lease, the productivity of the undrilled leases as indicated by nearby production, the rock pressures, and other matters appropriate for consideration in arriving at market value (R. IX, 4190). After having reviewed each lease separately, he placed it in a certain classification representing what was, in his opinion, the

then market value of the lease "from a willing seller to a willing buyer" (R. IX, 4195). He then tabulated the number of leases in each classification, fixing a market value as to each classification ranging in the Panhandle Field from $5 per acre to $100 per acre and in the Hugoton Field from $5 per acre to $35 per acre (R. IX, 4199, 4201). In the tendered narrative of his testimony, he stated (R. I, 4198):

> In valuing the leases of Panhandle Eastern Pipe Line Company, I have not considered as a value factor the fact that the wells drilled thereon are connected to pipe lines; nor have I attempted to place a value upon the wells or equipment used in connection therewith. The values shown in the tabulations reflect merely the present market value of the leases, according to my judgment. It is my opinion that if this acreage reserve owned by the Panhandle Eastern Pipe Line Company in the two fields was available, it could unquestionably secure an outlet for its gas, exclusive of any pipe line now in the fields and could be sold at the valuation fixed by me.

The valuation of $8,339,722 placed by the witness upon petitioners' 264,971 acres of gas leaseholds shows an average value per acre of approximately $31, whereas the average value per acre under the Commission's valuation was $3.60.

While the Natural Gas Act excludes the production and gathering of gas from the Commission's jurisdiction and permits it to exercise jurisdiction only over the interstate transportation of gas and over certain (not all) sales thereof in interstate commerce, the Commission has, by its order herein, found that petitioners are entitled to a price in the field for their gas, determined wholly on a consideration of the original cost of their leaseholds, less accruals for depletion and the application thereto of a 6½ per cent rate of return.

It is obvious that, if petitioners' leaseholds can now be sold for more than eight million dollars, an allowance of an earning on a value of less than one million dollars is wholy erroneous. It is to be assumed that the market value of the leaseholds is largely reflected in the market price, or the value of the gas, in the respective areas where it is produced. Such market price or field value is determined by many economic conditions, field transactions and local competitive factors having no relation to the original cost of the leaseholds.

This fact was pointed out by Mr. Justice Jackson in the *Hope* case and emphasized with a most vivid illustration. He said (320 U. S. 591, 649):

> Let us assume that Doe and Roe each produces in West Virginia for delivery to Cleveland the same quantity of natural gas per day. Doe, however, through luck or foresight or whatever it takes, gets his gas from investing $50,000 in leases and drilling. Roe drilled poorer territory, got smaller wells, and has invested $250,000. *Does anybody imagine that Roe can get for his gas five times as much as Doe because he has spent five times as much?*" (Emphasis supplied.)

A comparable illustration is presented by actual facts in this case. Evidence admitted by the trial examiner showed that, for 1940 (the last full year for which statistics were available at the time), petitioners paid for purchased gas an average field price of 3.8429¢ per MCF, whereas, for their own produced gas, under the Commission's formula, petitioners would have received only 2.9924¢ per MCF. Comparable figures for the test year, 1941 (based partly on estimates), were: 3.8336¢ per MCF paid by petitioners for purchased gas and 2.8272¢ per MCF, computed under the Commission's formula, realizable for gas which they produced.[24]

[24] See computations with record references, Appendix C.

This discrimination appears in more glaring form in the situation with respect to thirty-four wells jointly owned by petitioners and others (R. IX, 4153). Petitioners buy from the co-owners of these wells the share of such co-owners in the production at 5¢ per MCF (R. III, 1107). The result is that, for gas coming out of the same well, petitioners are allowed for their share, under the Commission's order, only 2.9924¢ per MCF, based on 1940 actual figures, or 2.8272¢ per MCF, based on 1941 figures, whereas, their co-owners receive 5¢ per MCF for their share. The Commission found no fault with the prices paid for purchased gas, in its allowance of operating expenses.

The evidence also showed that petitioners owned a particular group of thirteen producing wells, the gas from which was sold to Argus Natural Gas Company for distribution in nearby towns in Kansas. The wells were not even physically connected with any part of petitioners' transmission system, but were connected with the gathering system of Argus Natural Gas Company (R. I, 255-256; XIII, 5893; IX, 4138). The revenue derived from sales of gas from these wells to the Argus Natural Gas Company amounted to $67,365.40 for the year 1941. The average price paid by Argus Natural Gas Company to petitioners for this gas at the wellhead was 6.13¢ per MCF (R. XIII, 5707, L. 32). The Commission included all of these wells and the revenue derived therefrom in its unit treatment of petitioners' business. It also ignored this further evidence of the market value of gas at the wellhead.

Had the Commission admitted petitioners' evidence showing the market value of their gas leaseholds to be $8,339,722 and adopted that valuation in the rate base, the increased return thereon, applied to their production in 1941, the test year, would yield 1.8411¢ per MCF, which, added to the 2.8272¢ per MCF realizable under the Commission's valuation (as demonstrated in Appendix C) would have allowed petitioners for their gas at the well a price of 4.6683¢ per

MCF, as compared with 5¢ per MCF paid by petitioners to their co-owners of the jointly owned wells, 3.8336¢ per MCF average price paid by petitioners for gas purchased from other producers, 4½¢ per MCF paid by petitioners for royalty gas, and 6.13¢ per MCF paid petitioners by Argus Natural Gas Company for gas at the well.

We have demonstrated that the Commission's action in limiting the sale price of petitioners' gas for resale so as to provide an over-all return of 6½% on the depreciated cost of petitioners' properties, including those devoted to production and gathering of natural gas, and excluding petitioners' tendered evidence as to the market value of petitioners' gas leaseholds, was arbitrary, discriminatory, lacking any rational basis and amounted to a denial of due process. We submit that such action also constituted an exercise of jurisdiction over production and gathering of natural gas in violation of the Natural Gas Act.

CONCLUSION.

It is respectfully submitted that the judgment of the Circuit Court of Appeals be reversed and that the order of the Federal Power Commission be set aside.

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APPENDIX A.

The pertinent provisions of the Natural Gas Act of 1938, 52 Stat. 821, et seq. (15 U. S. C. Sec. 717) are as follows:

SEC. 1. (a) As disclosed in reports of the Federal Trade Commission made pursuant to Senate Resolution 83 (Seventieth Congress, first session) and other reports made pursuant to the authority of Congress, it is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest.

(b) The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

* * * * *

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission

shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

* * * * *

SEC. 6. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property.

* * * * *

SEC. 19. (b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be served upon any member of the Commission and thereupon the Commission shall certify and file with the court a transcript of the record upon which the order complained of was entered. Upon the filing of such transcript such court shall have exclusive jurisdiction to affirm, modify, or set aside such order in whole or in part.

No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 3[illegible] and [illegible]).

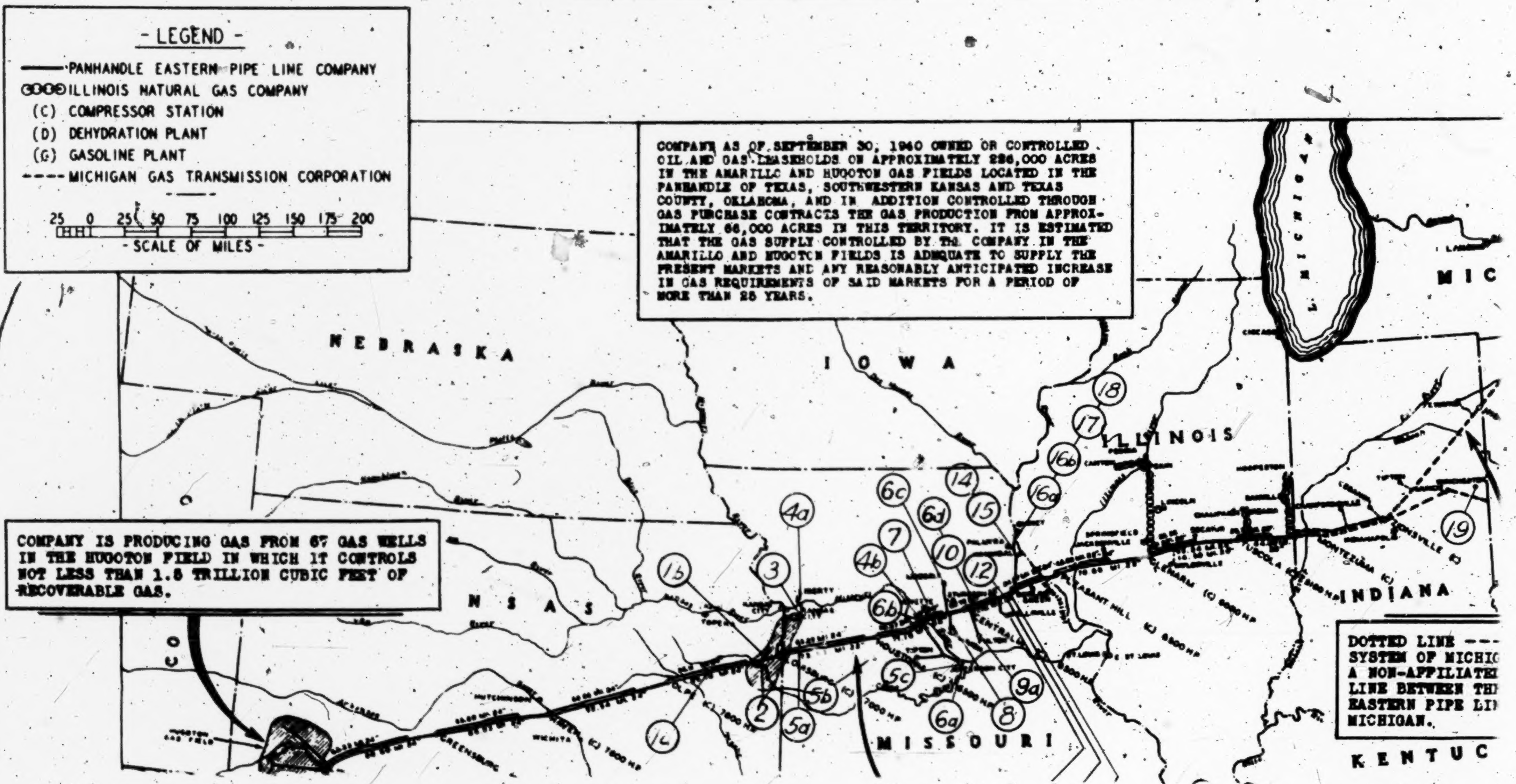
APPENDIX B.

Names of the nineteen industrial customers (Ex. 58, Schedule 3, R. IX, 4293) purchasing gas directly from petitioners, with locations of plants numbered to correspond with numbered locations superimposed upon map made a part of this appendix, which map was introduced as Chart No. 1 of Exhibit 65, R. X, 4559.

Customer Number	Name of Customer	Location of Customer's Plants Served
		Kansas
1	Phillips Petroleum Company	(a) Sharpe (b) Paola
2	State of Kansas	Osawatomie
		Missouri
3	United Brick and Tile Company	Vale
4	W. J. Small Company, Inc.	(a) Liberty (b) Boonville
5	Phillips Petroleum Company	(a) Harrisonville (b) Leeton (c) Jefferson City
6	Missouri Power and Light Company	(a) Jefferson City (b) Boonville (c) Moberly (d) Mexico
7	Fayette Brick and Tile Company	Fayette
8	Edwards-Conley Brick and Tile Company	Columbia
9	Harbison-Walker Refractories Company	(a) Fulton (b) Vandalia
10	Mexico Refractories Company	Mexico
11	Wellsville Fire Brick Company	Wellsville
12	North American Refractories Company	Farber
13	Walsh Refractories Corporation	Farber
14	Freiling Greenhouses	Hannibal
15	Universal Atlas Cement Company	Hannibal

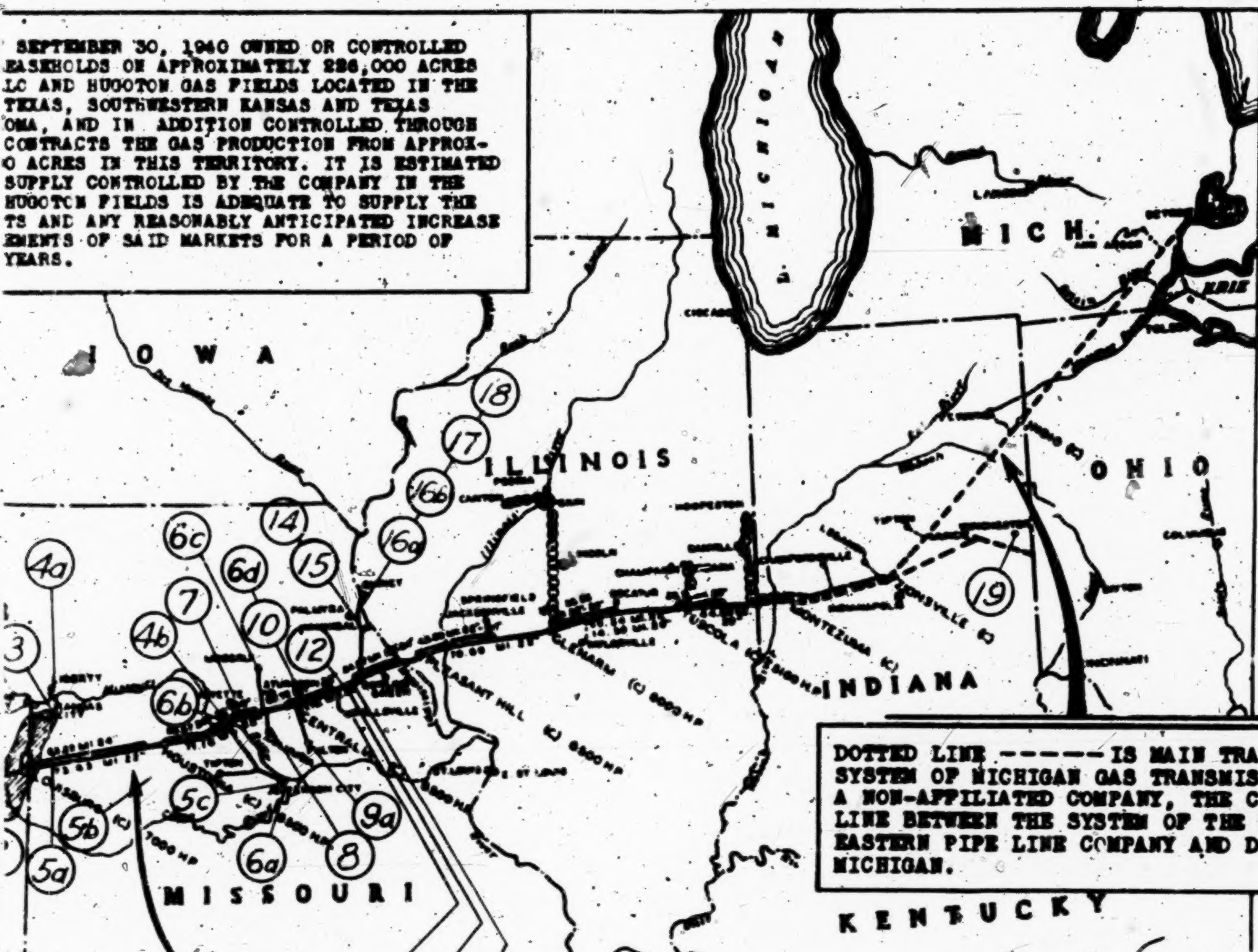
- CHART NO. 1 -

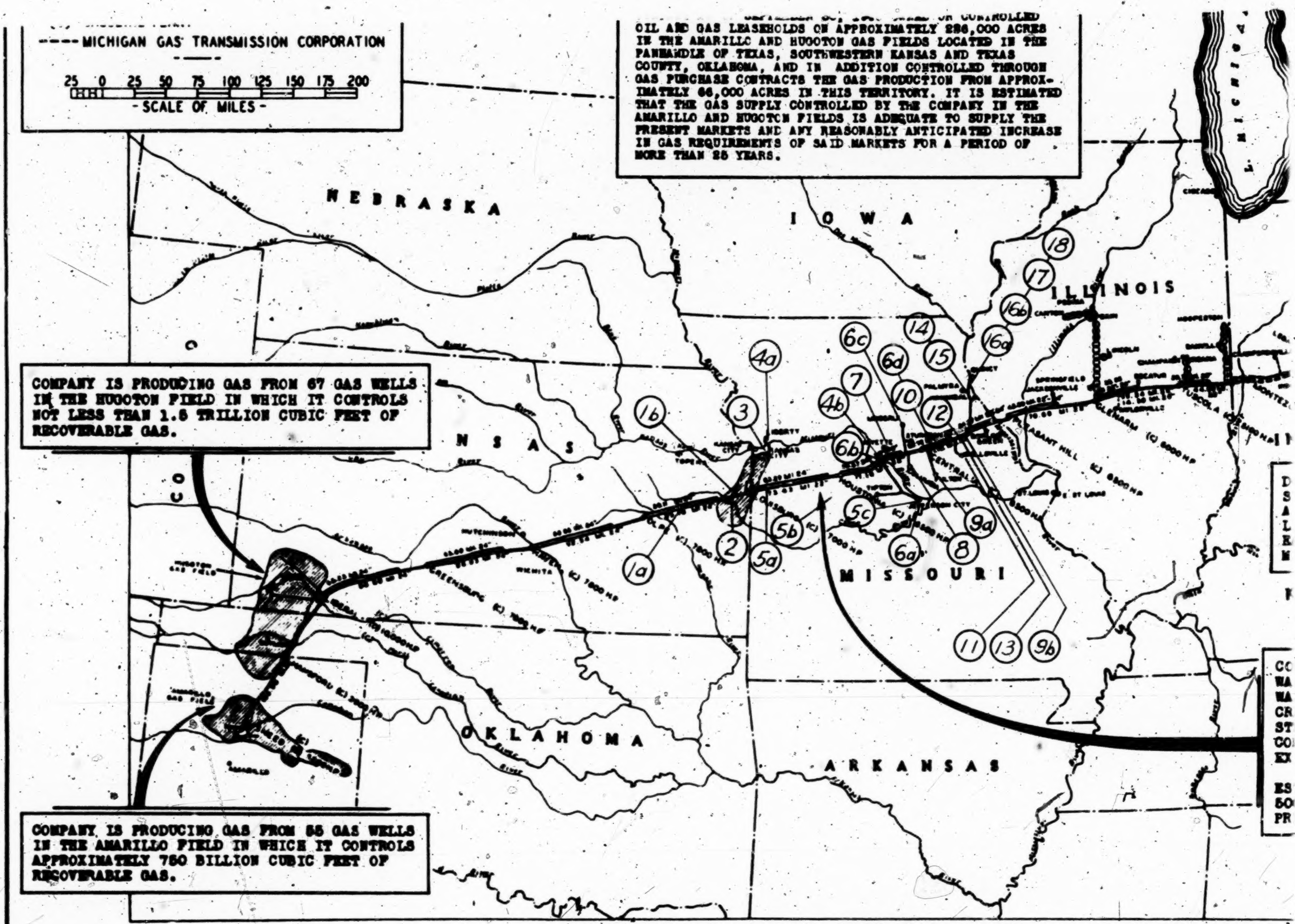
MAIN TRANSMISSION SYSTEM OF PANHANDLE EASTERN PIPE LINE CO. & SUBSIDIA



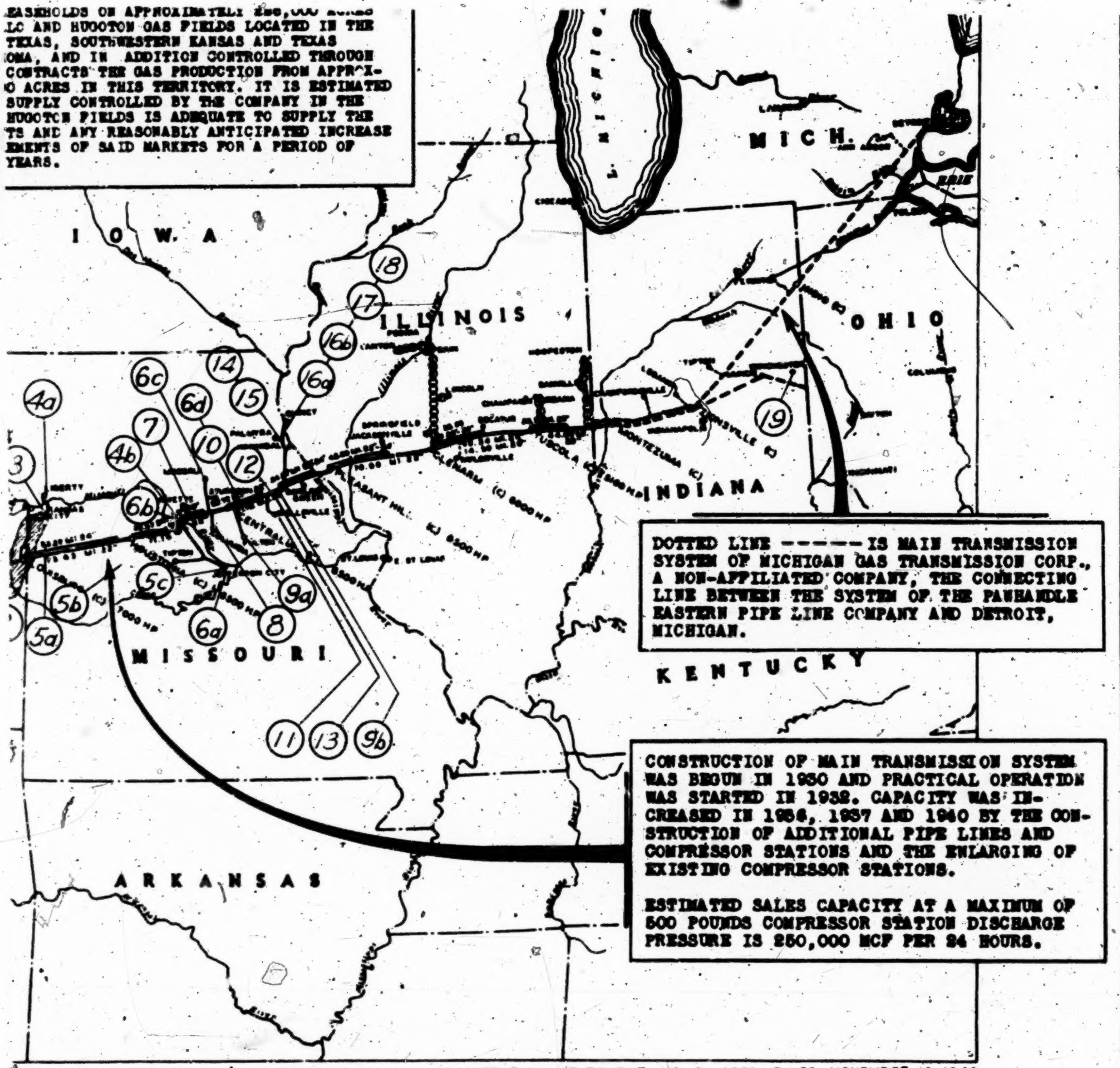
-CHART NO. I-

SMISSION SYSTEM OF
PIPE LINE CO. & SUBSIDIARY





SOURCE - MAP FROM 1940 ANNUAL REPORT, OTHER DATA FROM S. E. C. REGISTRATION STATEMENT N



940 ANNUAL REPORT, OTHER DATA FROM S. E. C. REGISTRATION STATEMENT NO. 2-4579, FILED NOVEMBER 18, 1940

		Illinois
16	Marblehead Lime Company	(a) Marblehead (b) Quincy
17	Menke Stone and Lime Company	Quincy
18	Black White Lime Company	Quincy
		Indiana
19	Anchor-Hocking Glass Corporation	Winchester

APPENDIX C.

COMPARISON OF WELL-HEAD PRICE PER MCF REALIZABLE UNDER COMMISSION'S FORMULA BY PETITIONERS FOR GAS PRODUCED WITH AVERAGE FIELD PRICE PER MCF PAID BY PETITIONERS FOR GAS PURCHASED, FOR THE YEARS 1940 AND 1941

	1940 Cents per MCF	1941 Cents per MCF
COMPUTATION OF PRICE FOR PRODUCED GAS		
(a) Production Cost per MCF		
Schedule 3, Exhibit 142, R. XI, 5031 (for year 1941, six months actual and six months estimated) excluding amount paid for purchase of royalty gas..	0.7435	0.9266
(This cost does not include carrying charges on the cost of reserves, the cost of existing facilities, or facilities to be added subsequent to the years 1940 and 1941, nor does it include amortization, depletion, depreciation and replacements with respect to production system properties R. XI, 5026)		
(b) Amortization of Unoperated Leaseholds Allowed by Federal Power Commission		
Year 1940 $80,408.63, total amortization (Schedule 1, Exhibit 173, R. XII, 5443) divided by 22,382,000 MCF Produced (7/8 of 25,578,900)	0.3593	
Year 1941 $74,685.45, total amortization (Schedule 1, Exhibit 173, R. XII, 5443) divided by 26,072,000 MCF Produced (7/8 of 29,796,400)		0.2865
(c) Depletion Allowed by Federal Power Commission:—		
Year 1940 $79,736.27, total depletion allowance (Schedule 1, Exhibit 173, R. XII, 5443) divided by 22,382,000 MCF Produced (7/8 of 25,578,900)	0.3562	
Year 1941 $90,177.06, total depletion allowance (Schedule 1, Exhibit 173, R. XII, 5443) divided by 26,072,000 MCF Produced (7/8 of 29,796,400)		0.3459

(d) Computation of Depreciation Allowed by Federal Power Commission:—

Cost of Depreciable Production Property (Excluding Gathering and Gasoline Facilities)

	1940	1941
Line 13, Page 1, Schedule 176, R. XII, 5453	$ 299.00	$ 299.00
" 15, " 1, " " " " "	46,426.96	47,797.15
" 17, " 1, " " " " "	2,023,739.02	2,067,934.08
" 19, " 1, " " " " "	592,983.62	604,915.00
" 21, " 1, " " " " "	20,762.34	20,691.46
" 24, " 1, " " " " "	399.08	826.16
Total	$2,684,610.03	$2,742,462.85

	1940 Cents per MCF	1941 Cents per MCF
Year 1940 $2,684,610 × 6% = $161,079 divided by 22,382,000 MCF Produced (7/8 of 25,578,900)	0.7197	
Year 1941 $2,742,462 × 6% = $164,548 divided by 26,072,000 MCF Produced (7/8 of 29,796,400)		0.6311

(e) Computation of Return Allowed by Federal Power Commission:—

	1940	1941
Cost of Depreciable Production Property (Excluding Gathering and Gasoline Facilities)	$2,684,610.03	$2,742,462.85
Cost of Operated Leaseholds Line 10, Pg. 1, Ex. 176, R. XII, 5453	996,613.19	1,017,993.19
Cost of Unoperated Leaseholds Line 12, Pg. 1, Ex. 176, R. XII, 5453	759,239.20	747,784.12
Total Cost of Production Property	$4,440,462.42	$4,508,240.16

Year 1941 \$2,742,462 × 6% = \$164,548 divided by 26,072,000 MCF Produced (7/8 of 29,796,400) 0.6311

(e) Computation of Return Allowed by Federal Power Commission:—

	1940	1941		
Cost of Depreciable Production Property (Excluding Gathering and Gasoline Facilities)	\$2,684,610.03	\$2,742,462.85		
Cost of Operated Leaseholds Line 10, Pg. 1, Ex. 176, R. XII, 5453	996,613.19	1,017,993.19		
Cost of Unoperated Leaseholds Line 12, Pg. 1, Ex. 176, R. XII, 5453	759,239.20	747,784.12		
Total Cost of Production Property	\$4,440,462.42	\$4,508,240.16		
Less Reserves				
Depreciation (for computation see schedule below)	\$ 927,961.00	\$1,090,528.00		
Depletion Line 32, Page 2, Exhibit 172, R. XII, 5439	356,987.61	447,164.67		
Amortization Line 33, Page 2, Exhibit 172, R. XII, 5439	353,557.18	415,074.53		
Total Reserves	\$1,638,505.79	\$1,952,767.20		
Depreciated Cost of Production Properties	\$2,801,956.63	\$2,555,472.96		
\$2,801,957 × 6½% = \$182,127 divided by 22,382,000 MCF Produced (7/8 of 25,578,900)			0.8137	
\$2,555,472 × 6½% = \$166,105 divided by 26,072,000 MCF Produced (7/8 of 29,796,400)				0.6371
PRICE FOR PRODUCED GAS (TOTAL COST AND RETURN ALLOWED BY FEDERAL POWER COMMISSION)			2.9924	2.8272
AVERAGE PRICE PAID FOR GAS PURCHASED—Exhibit 142—Total of lines 3 and 25; Schedule 2, R. XI, 5029, and lines 7 and 24; Schedule 3, R. XI, 5031, divided by total of line 39; Schedule 2, R. XI, 5029, and 1/8 of line 37; Schedule 3, R. XI, 5031				
1940—\$1,134,306 ÷ 29,517,000 MCF			3.8429	
1941— 1,300,654 ÷ 33,928,000 MCF				3.8336
DIFFERENCE			.8505	1.0064
PRODUCTION MCF (reduced to nearest thousand)			22,382,000	26,072,000
AGGREGATE DIFFERENCE IN DOLLARS			\$ 190,400	\$ 262,400

Computation of Depreciation on Production Properties Allowed by Federal Power Commission

At December 31 Year	Cost	Average Cost Per Year	Depreciation at 6%
10/1/36 (1)			\$ 369,323
1936	\$1,452,675	\$1,452,675	14,526 (2)
1937	2,096,917	1,774,296	106,487
1938	2,340,235	2,218,576	133,115
1939	2,564,860	2,452,548	147,153
1940	2,680,368	2,622,614	157,357
1941	2,738,526	2,709,447	162,567
Total at December 31, 1941			\$1,090,528
Total at December 31, 1940			\$ 927,961

(1) From records of Texas Interstate Pipe Line Company—10/1/36.
(2) 1/6th year.